THE LIMITATIONS OF FOREIGN CREDITS[1]

The extension of credit by the United States to Europe has been repeatedly urged as the only solution of the European problem. Immediately after the Armistice there were official suggestions of huge American loans of ten or fifteen billion dollars for reconstruction work in France alone. While the total figures have, in the intervening months, been gradually whittled down to more commensurable terms, there has—until recently at least—been little abatement of confidence in foreign credits as the panacea for the European situation. It is the purpose of this article to review briefly the history of foreign credits since the war and point out the rigid limitations upon further loans as a solution of the European problem.

The war caused an enormous dislocation of international trade and disturbance of financial operations. It may be recalled that the great increase in exports from the United States, as well as from neutral countries, resulted: (1) in shifting a disproportionate quantity of the gold supply of the world to the United States; (2) in the resale of the United States of European investments in American securities; and (3) in the creation of huge foreign debts to the United States. In four swift years the Unites States was converted from the greatest debtor to the greatest creditor nation in the world. The outstanding effect of this shift in American trade and financial position has been to depreciate European currencies as compared with the American dollar. The outflow of gold contributed to the abandonment of the gold standard in Europe, while the disruption and maladjustment of international trade and the redistribution of international securities added to the depressing effects upon the European exchanges.

The three years that have elapsed since the conclusion of the war have only served to increase this maladjustment between the Old World and the New. European domestic currencies, speaking

[1] From John F. Bass and Harold G. Moulton, *America and the Balance Sheet of Europe*. The Ronald Press, 1921.

generally, have still further depreciated; our trade exports have until the last year been even larger than during the war period; European loans from the United States have been increased by several billions of dollars; and huge additional quantities of gold have flowed from the depleted coffers of Europe to the banking institutions of the United States. In consequence the exchange situation is now as distressing a problem as ever, and international financial reorganization in general is quite as far from accomplishment as at the time of the armistice.

Even before governmental control of the exchanges was abandoned in the spring of 1919, numerous students of international finance had pointed out that the United States must increase its investments of foreign securities if depreciation of the exchanges was to be prevented. Depreciation of the exchanges, it may be recalled, is in part[1] caused by an excessive supply of bills of exchange. Now whenever anyone in the United States invests in foreign securities he demands bills of exchange with which to pay for the securities purchased. Accordingly, if Americans will buy foreign securities in amounts equal to the excess of the supply of bills of exchange over the ordinary demand therefor, the total demand and supply will be equalized and exchanges will rise toward par. One must say *toward* par rather than *to* par, for the reason that actual parity cannot be attained until European nations are once more on the gold standard. Foreign investments are therefore looked to as a means of lessening the depreciation of the European currency.

American foreign trade would be facilitated by this appreciation of the European exchanges; for the disadvantage of buying in American markets would be lessened to the extent that the depreciation of the European exchanges as compared with the dollar was lessened. It should be understood at the same time, that these investments in foreign securities give to foreigners increased purchasing power and this enables them to increase to that extent their purchases of goods in the United States. Indeed, the making of foreign investments really means shipping goods abroad on credit. One should recall in this connection that the

[1] In part, also, by depreciated paper money in Europe.

present huge foreign debts to the United States were largely created by the shipment of war materials to the allied nations.

Such is the argument for an extension of American credits abroad. Most European countries still apparently need American credits. And America would like to extend the credits if possible, in order to stimulate our exports and thus revive industrial prosperity here. Foreign credits therefore appear to constitute a central feature in any program of international reconstruction.

Our foreign-credit experience.—Before undertaking to discuss the main issue, namely, how far foreign credits will now suffice to restore world prosperity, it will be helpful to survey briefly the history of American foreign investments since the war. The need of extending financial assistance to Europe was first strikingly presented in the United States by Mr. Vanderlip, then president of the National City Bank of New York. In Mr. Vanderlip's view, if Europe were to recover from the enormous loss of the war and escape political and social disintegration, it was imperative that the wheels of industry be started by means of a vast loan from the United States. Since the security of individual European enterprises could not find a ready market with American investors, and since every portion of Europe must be given assistance if the specter of bolshevism were to be effectively laid, Mr. Vanderlip urged that there must be a pooling of all European resources, whereby one gigantic loan might be extended to Europe as a whole, secured by a joint guaranty of the several European governments, with liens upon customs revenues as security.

Mr. Vanderlip's proposal fell upon deaf ears, partly because it called for a mobilization of world financial resources on a scale too stupendous for the average man to grasp, but mainly because Mr. Vanderlip's views as to the gravity of the European situation were shared by few American business men. In the spring of 1919 the overwhelming majority of Americans believed that vociferously expressed optimism was about all that was required to restore the losses of the war. Did not the great need of the world for increased production provide the basis for a long period of intense business activity and prosperity for everyone? A pessimist —even an intellectual one—was regarded a national menace.

The utilization of banking credit.—Meanwhile credits continued to be extended to Europe. The government continued to make loans, the total increasing from less than nine to approximately ten billions in the year following the armistice. In the main, however, post-war credits to Europe were extended in another way—one that had not been contemplated to any great extent and one that on grounds of financial theory was not to be countenanced.

American business men expected commodities on what were presumed to be short-term commercial credits. The exporters, as is the custom, financed their needs, pending the receipt of payments from abroad, by borrowing from the commercial banks. The process of course resulted in a great expansion of bank loans and in a rapid lessening of commercial-bank reserves in this country. Europe was thus enabled to get the goods required, and American business received a great stimulus, one of the results of which was rapidly mounting prices.

I have said that the loans were presumably made for short periods only. It developed, however, that in consequence of Europe's inability to pay, these loans of the bankers to American business men had to be renewed again and again—in fact, indefinitely. The result was that for all practical purposes they became long-term credits. These credits are still in the main owing to American business men, who in turn are still indebted to the banks for the amounts involved, which run into billions of dollars.

This process of extending credits, however, eventually ran its course. When the reserves of the federal reserve banks were reduced as a result of this and other causes to the danger point—that is to say to a point beyond which they could not go without precipitating a financial panic or resulting in our passing from a system of gold redemption to one of inconvertible paper—it had to be altered.

It was recognized all along by leading financiers and economists that this method of financing foreign trade was unsound and should not be allowed to continue even if it could. Europe wanted the goods, however, and American exporters wanted the sales; and with no other means of financing available, both exporters and

bankers appeared willing to take the chance—small chance, it was assumed—because Europe was to come back with giant strides.

The other possible means of financing Europe's needs was by long-term investment credits. Investment in foreign securities by the American people was severely hampered, however, because of inadequate financial machinery for the purpose. In brief, the American investor was unfamiliar with the merits of European securities, and was unwilling to assume the risks involved. Some means was needed whereby he could invest in the securities of American financial corporations, backed by the European securities as collateral. European nations, particularly Great Britain, had long had foreign financing corporations known as investment trusts, which made it possible for British investors to invest abroad with a minimum of risk. The principle underlying such financial institutions is in brief as follows: The foreign securities are purchased by the investment trust or financial corporation and placed in trust as collateral security for its own bonds which are sold to investors within the country. The individual thus purchases the obligation of a well-known, domestic financial institution rather than one of a relatively little-known foreign corporation. Moreover, he is able to distribute his risks more widely; his security is in effect the combined earnings of all the foreign borrowers whose bonds are held as collateral security, in addition to the capital resources of the investment trust itself.

It was not until December, 1919, that the necessary congressional legislation could be secured for the formation of such financing corporations under federal law. The Edge Act then finally authorized the establishment of American investment trusts popularly designated here as foreign financing corporations. It was another twelve months, however, before any large effort was put forth to organize financing institutions under the provisions of the law. There had already been two or three financing corporations organized under state law, and early in 1920 one was organized under the Edge law. But the inability of these corporations, which were of only moderate size, to solve the problem became so apparent that in December, 1920, an effort was made to launch a huge foreign financing corporation, one that would be worthy of American financial genius.

A capital of $100,000,000 was determined upon, which would make possible the purchase and sale of securities to the amount of one billion dollars. A nation-wide campaign of education was undertaken, with a view to enlisting the interest of all classes of business men—financial, manufacturing, commercial, and agricultural. Even the interest of laborers as potential investors was besought.

Almost another year has elapsed and this corporation has been unable to secure the necessary capital, owing to a combination of factors, including the business depression and the outright opposition on the part of many leading financiers. The chief objection to the plan is that the organization of a corporation of such tremendous size is unnecessary and even dangerous when it is by no means certain that there is any great volume of foreign-security business in sight. It is feared, moreover, that it will be impossible to secure the personnel with which to administer so large and so difficult an undertaking.

One of the greatest difficulties on the administrative side is that of making certain that the securities offered are safe. Lack of definite knowledge of the standing of individual European borrowers is one handicap. But much more important is the general insecurity of conditions in Europe. The individual borrower may appear to be sound enough, both financially and morally. But the instability of the exchanges, the disruption of transportation, the disorganization of commercial relationships, social unrest, and political instability, combine to multiply the risks which the lender must asssume. Improved organization of the credit machinery of Europe is now universally conceded to be necessary if American credits are to be greatly extended.

In this connection it is noteworthy that none of the overseas financing corporations, that have been organized by the largest financial interests in the United States, have thus far succeeded in developing any appreciable volume of business. Without exception, they have found the practical difficulties of an insuperable character.

The "Ter Meulen" plan.—With a view to overcoming the present insecurity of European investments there has been

developed during the last year the so-called "Ter Meulen" scheme, named after its originator, a prominent Dutch financier. This plan has been indorsed by the International Financial Conference, which was held in Brussels, in the autumn of 1920, under the auspices of the League of Nations. It has since been indorsed by the Council of the League of Nations and by the International Chamber of Commerce at its conference in London, June, 1921. The Ter Meulen plan therefore is the next experiment in extending credit to the distressed nations of Europe.

In brief, the purpose is to encourage export trade by providing a special form of security which will reinforce the credit of the European importers. The exporter, as under present conditions, seeks out his own customer in Europe, arranges the terms of sale, and investigates the credit standing of the buyer. But in order to improve his credit standing, and thus make it possible to purchase the goods required on more favorable terms, the importer approaches his government and borrows from it for the period of the credit Ter Meulen bonds which he may use as collateral for his own promise to pay. Each borrowing government will arrange the conditions under which it will loan bonds to its citizens. But before the whole transaction is completed there must be obtained the approval of an international commission to be appointed by the League of Nations. This commission must satisfy itself that the imports consist of "necessary" commodities. It must also see that the total amount of bonds authorized for issue is not exceeded. Thus international, nonpartisan, and presumably scientific control is secured.

To make the credit sound it is obvious that there must be satisfactory security back of the government bonds. The plan therefore provides that the governments which issue the bonds shall pledge as security revenue-producing assets (to which a gold value can be assigned) of sufficient amount to satisfy the international commission. It is suggested that the most suitable assets for the purpose will be export and import duties and revenues from state railways, government monoplies, forests, etc.

Now in case the importer is unable to pay for the goods when payments are due the exporter who has extended the credit may

seize the collateral security—the Ter Meulen bonds—in satisfaction of his claims. These bonds he may then either hold as an investment or sell in the investment market. It will doubtless be provided, however, that if he wishes to sell the bonds they must first be offered to the issuing government, so that it may buy them in if it so desires. It should be added that these Ter Meulen bonds may be sold to American investors through the foreign financing corporations; or they may be pledged as collateral by the financing corporations against their own securities, which may be issued for sale to American investors. The rate of interest on these bonds will be fixed by each country. While all of the details have not been determined—to our knowledge—it is suggested that the rate should be the normal rate that such country might expect to have to pay in the open market. The duration of the bonds will doubtless be from five to ten years.

It should be observed that the Ter Meulen scheme has three principal features. First, it permits in large measure the utilization of existing trade and financial practice and machinery. The export may be arranged as heretofore through ordinary private channels; and the Ter Meulen bonds may be marketed through the already established financial agencies. Second, it permits the greatest possible amount of flexibility, allowing the methods to be adjusted to the varying conditions in different countries. Third, and this is the heart of the plan, it sets up machinery for placing back of the credit of the individual the credit of his government.

What now is the hope from this Ter Meulen scheme? Will it solve the problem of overseas credit, and thus make possible an early restoration of European trade and industry? My conclusion is that the Ter Meulen plan will not prove of great importance. It is worth trying out if only for the lessons to be learned from such a trial. And here and there no doubt some credit will be extended through the aid of Ter Meulen bonds. But the plan will fail of accomplishing large results for the reason that it does not reach to the heart of the European question.

So long as the budgets of European countries remain unbalanced, and so long as imports remain greatly in excess of exports, Europe will not be able to pay interest on Ter Meulen bonds. The

revenues which are to be set aside for the purpose in hand are vitally necessary for ordinary fiscal requirements. When a nation's revenues are, for example, but half the ordinary expenses it may conceivably prove possible for an international commission to appropriate what revenue there is for the payment of interest on Ter Meulen bonds. But this would not prevent a continuously unbalanced internal budget in the country in question and thus a progressive deterioration of the internal economic organization. On the contrary, it would intensify the budgetary difficulties. Now if budgets are not balanced, it will prove impossible to prevent the Ter Meulen bonds from depreciating in value, thereby reducing their marketability in the investment markets. To present the question, "What would have been the fate of German or Polish Ter Meulen bonds in the light of the recent fall of Polish and German marks?" is to answer it.

In consequence of considerations such as these, it is not at all certain that American and British exporters will be quick to try out the plan. While supporting the scheme as one that contains some possibility, Mr. A. J. Jobson, chairman of the British delegation at the June meeting of the International Chamber of Commerce in London, warned British exporters against too free a use of the plan. He pointed out that not even a stock-exchange speculator would be willing to buy the securities of corporations which possessed a power of increasing without limit their outstanding obligations. So long as European governments have the power of unlimited issue of paper currency, the wise business man will proceed the caution in accepting Ter Meulen bonds.

Can the United States finance additional overseas credits?—It remains to be noted that there is little chance that British and American investors, particularly the latter, will be either willing or able to absorb any considerable volume of Ter Meulen bonds. So far as England is concerned, her investment capacity has been enormously reduced in consequence of the staggering burden of post-war taxation. As regards the investing capacity of the United States, it will be recalled that the credits extended to Europe during 1919–20 were largely banking credits, the funds coming from bank-loan expansion rather than from investment savings. Indeed,

except during the war period when, under the spur of large monetary profits and wages and under the lash of the liberty loan campaign, we patriotically bought liberty bonds and thus enabled the government to make loans abroad, the United States has shown little capacity to furnish foreign capital. It must be recalled, moreover, that of the ten billions of funds loaned by the United States government abroad, a very considerable percentage does not represent real savings, but only bank-credit expansion. Moreover during the period of the war our investments in railroad, public utility, and housing enterprises were summarily curtailed. Looking ahead there is little possibility of our financing overseas investments in addition to domestic requirements so long as business depression continues. And in case we have a business revival, the volume of domestic loans to be floated will severely tax our entire investment capacity.

It will assist to an understanding of the future of American foreign creditors if it is clearly appreciated that it is an anomaly for a nation such as the United States to be in the position of creditor to the rest of the world. No nation ever before became a great creditor when its own internal industrial resources were so partly developed as is the case with the United States.

England, to take the best example of a "legitimate" lender of foreign capital, began to emerge as a creditor nation when the volume of her annual savings exceeded the requirements of her domestic industries. These excess savings then naturally sought overseas employment; indeed they were *forced* to seek a foreign outlet. The machinery for making such investments, moreover, gradually developed to meet the needs of the gradually changing industrial and financial status of the nation. In a word, England arrived at her creditor position as a result of many generations of gradual development; in consequence her economic organization was never thrown out of adjustment as a result of the process.

The present financial position of the United States is, however, fundamentally different. We have become almost overnight a huge creditor nation. As a result of temporary war demands, we forced the development of our manufacturing capacity much in excess of ordinary domestic requirements, and thereby we were

enabled to repurchase European holdings of American securities and to extend the vast loans which converted us from a great debtor to a great creditor nation. We are now seeking to accomplish the impossible—to make permanent the foreign markets which the temporary exigencies of the war provided.

Moreover as a creditor nation, England had an unfavorable balance of trade, receiving the interest on her foreign investments in the form of an excess of imports over exports. The United States, on the other hand, is in the anomalous position of hoping to maintain a permanent large excess of exports over imports at the same time that it receives interest on the huge foreign investments that grew out of the exigencies of war financing. We might as well attempt to make water run uphill. In view of our excess manufacturing capacity and the present adjustment of our whole economic organization to the production of goods for export, we are not in a position to face the prospect of having interest paid in goods, with economic composure. The situation is fundamentally different from that of England before the war where the position as a creditor nation was attained gradually as a result of normal trade and financial processes.

In any case, it is idle to suppose that we could finance huge additional credits. Our own internal industries, particularly those that were neglected during the war, will continue to require substantially all of the investment resources of the country. In the absence of the war there is little, if any, doubt that the United States would have continued to be a borrowing nation for many years to come; the events of the war have in no way changed the fundamental requirements of the situation; they have merely demoralized the trade and financial relations of nations and raised the most difficult problems of economic reorganization the world has ever known.

The American position with reference to future foreign loans was strongly presented at the International Chamber of Commerce meeting in London by George E. Roberts, vice-president of the National City Bank of New York. After observing that the United States is still a new and undeveloped country and that over a large part of the nation the people are accustomed to devote

their savings mainly to the extension of their own immediate businesses or to investment in local enterprises, he pointed out other reasons which render large additional American investments abroad impossible. He stated that

> the competition for capital for domestic enterprises has made interest rates high, and the new offerings of securities at high rates has had the effect of depressing entire lists of outstanding securities and stocks, so that they yield high returns upon present prices. Other factors in the situation are the high rates of taxation and the fact that municipal securities, to some extent, and bonds of the federal government are exempt from taxation. The total amount of securities wholly exempt now outstanding is estimated at approximately 15 billion dollars and is being constantly increased by new issues. . . . . The presence of this large body of tax exempt securities has the effect of practically eliminating investors of high incomes as buyers of securities subject to taxation. To an individual of an income subject to our maximum tax rate, an exempt 4 per cent federal or municipal bond yields an equivalent of 14.81 per cent interest. Conversely, a taxable 7 per cent investment, such as a real estate mortgage, an industrial or railroad bond, or a foreign government bond, after tax payments actually yields, under the higher schedules, less than 2 per cent. This calculation is based on federal taxes only, and there is local taxation to be considered besides.

These considerations take the wealthy investors out of the market for European securities, except at rates of interest which Europe would regard as utterly extortionate.

This fact, coupled with other considerations already noted, makes it impossible for the United States to finance Europe henceforth on any very extensive scale. All of our experience up to date confirms this judgment. We trust there will be no misunderstanding here; we are not contending that a great many millions may not still be extended. But the days of billions of overseas credit are definitely past, for at least a generation. The only possibility of extending the credits would be through a renewal of exporters sales on credits furnished through further bank inflation. In view of the fact that much the greater part of the credits thus extended are still unpaid, with American exporters and their bankers pocketing the losses, there is little likelihood of an extensive resumption of this process.

One further plan of extending foreign credits has been frequently suggested, among others, by Frank A. Vanderlip and Sir George Paish, formerly editor of the *London Statist* and widely known as a

writer on international trade and finance. In the views of these men the problem of Europe must be conceived as one problem; that is to say, it is idle to talk of extending credits to this, that, or the other, particular individual in Europe or to this, that, or the other, particular government in Europe. The problem must be dealt with on a continental scale; there must be a pooling of all European resources whereby large loans may be extended to Europe as a whole, secured by the joint guaranty of the European governments. Sooner or later, it is believed, this will have to be done if Europe is to be saved. International action *alone* will suffice.

This is undoubtedly sound doctrine; because of the essential unity of the world economic problem. But we would still have to face the restricted absorbing capacity of the American (and British) investment markets. Such a loan, if it did not exceed a few hundred millions might be absorbed in the course of a few years. If it ran into billions it could not be handled.

Huge additional credits not the principal remedy.—When all is said and done the way out for Europe and the world does not mainly lie in huge additional credit extensions by the United States to Europe. No one can have an appreciation of the sources of disturbance in international economic relations until he clearly understands that the cause of the international maladjustment including the depreciated exchanges has been too much *buying* from the United States. European holdings of American securities have been traded for American goods; European gold has flooded the United States in exchange for American goods; and other billions of our goods have been shipped abroad on credit. The result has been an unbalancing of the economic and financial equilibrium of the world on a scale that no one before the war would have conceived possible.

The remedy for this malady is not more of the same medicine. Additional foreign investment by the United States will not bring the exchanges back to par; on the contrary, it will depreciate them still more. Temporarily, while the exchange with which to make investments is being purchased, exchange quotations may rise; but shortly—when interest becomes due—there will be a tendency toward still further depreciation. This might be theoretically

offset by new foreign investments the year following, investments in excess of the interest charges on the old, and so on indefinitely. It must be recognized, however, that a time must shortly come when our new investments would be less in volume than the interest on the old investments. When this becomes true the net effect on exchange rates will be one of depression.

So much for theoretical possibilities: The practical situation is that we have already reached a point where new investments are not equal in volume to the interest on existing foreign debts. The only reason why the depressing effects upon the exchanges is not more fully manifest is that thus far we have not been asking foreign debtors to pay us interest. If we should insist upon the payment of interest on the foreign debt European exchanges would immediately suffer heavy depreciation. In the words of George E. Roberts before the International Chamber of Commerce in London:

> If in the present state of trade the United States should ask for the payment of accrued interest upon these loans and the debtor governments should go into the markets and attempt to gather up exchange to make the payments, the effect would be to raise exchange rates on New York still bigher and bring our foreign trade to a standstill. In short, the United States cannot afford to accept payment of either interest or principal from the debtor governments at this time.

The economic rehabilitation of Europe and the restoration of international trade and prosperity are not, ultimately, to be secured by increasing our loans to Europe from fourteen to fifteen to sixteen to eighteen and to twenty and thirty billions. Such a development would only intensify the world-maladjustment which we are seeking to correct. All this is not to say, however, that there may not still be an interval of time during which Europe will have to borrow more. She may perhaps find it necessary to go somewhat further into debt before she can pull together and begin the process of getting out. But in the nature of things Europe cannot expect to borrow much more. The several billions that have been borrowed since the armistice have not placed Europe on her feet; on the contrary, every nation in Europe, England not excepted, is in a worse financial plight today than it was two years ago. It is possible, though not certain, that conditions might have been

still worse if we had not extended huge post-war credits. Be this as it may, if Europe has nevertheless continued to go backward, the argument for additional credits loses all point, except as viewed from the standpoint of humanitarian considerations. Certainly, if some additional credits are to be granted there must be absolute assurance that they will be utilized only for essential purposes, and not squandered on stupid consumptive extravagance, or in equally stupid military adventures which only serve to intensify the political and economic instability of Europe.

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